Common Stock Fundamentals

For More Information Visit

Bbsnotes.com

Chapter-6

COMMON STOCK FUNDAMENTALS

Common stock:

→ Common stock is a major source of long term capital. By selling common stock to the investors, company receives capital permanently.

→ The life of common stock will not be fixed. (i.e upto ∞)

→ The dividend of common stock will not be fixed at the time of issue.

→ Income of the common stock holder from the investment in the common stock are expected dividends and capital gain, that will be realized from the increase in market value of common stock.

→ From investor's view point, common stock is more riskier than bond due to residual claim on income and assets (at the time of liquation.)

→ From company's view point, common stock is less risky than bond because like bond common stock holders do not have right to liquidate the company if company failed to pay dividend in common stock.

→ Common stock has limited liabilities.

Formula:

$$\text{Dividend Yield} = \frac{\text{Dividend}}{\text{close price}} \times 100$$

$$\text{Price-Earning ratio (PE Ratio)} = \frac{\text{Price}}{\text{Earnings}}$$

* Stock split:

It is simply increase in number of shares outstanding through appropriate decrease in par value per share of stock. It is done to decrease market value per share of common stock.

After stock split:

1. Number of shares outstanding increases
2. Market value per share decreases
3. Book value per share decreases
4. Par value per share decreases

Formula:

1. No. of shares after stock split = No. of shares before stock split x stock split ratio

2. MVPS | BVPS | PV after stock split = $\frac{\text{MVPS | BVPS | PV before stock split}}{\text{Stock split ratio}}$

* Stock dividend:

If the company distributes its earnings to its share holders in the form of shares rather than cash, is called Stock dividend or bonus shares. It is done to raise the capital by the firm.

After stock dividend:

1. Number of shares Increases
2. Market value per share Decreases
3. Book value per share Decreases
4. Par value → No change

Formula:

1. No. of shares after stock dividend = No. of shares before stock dividend (1+SDR)

2. Bvps|Mvps after stock dividend = $\frac{\text{Bvps|Mvps before stock dividend}}{1+SDR}$

where,

SDR = Stock Dividend Rate

Problem 6.1

Soln

a. The trading activity occured on a day before the day of quotation. The day of quotation is Monday, June 5 so, the trading occured on Sunday June 4.

b. The close quote is 299, which implies that the stock sold at price of Rs. 299 at the end of the day on Sunday June 4.

c. The firm's price-earnings ratio is 14.95 times. It indicates that closing market price Rs. 299 of sunday June 4 is 14.95 times of the recent annual earnings per share.

d. The last price at which stock traded on the date quoted is the closing price Rs. 299.

e. The dividend of Rs. 10.50 per share is expected in the current year.

f. During the latest 52-weeks period stock traded at the highest price of Rs. 352 and the lowest price of Rs. 290 per share.

g. 432 round lots or 43,200 shares (432x100) were traded on the day quoted.

h. The stock price declined by Rs. 1 per share on the day quoted as compared to the immediately preceding day. The preceding day's close price was Rs. 300.

Preceding day's close price = close price - net change
= 299 − (−1)
= 299 + 1 = Rs. 300.

Problem 6.2

Soln

a. The 52-weeks high and low price indicates the highest and the lowest stock price over the recent 52-weeks period. During the period, maximum stock price was Rs. 77.5625 and minimum price was Rs. 40.0625.

b. Dividend Yield is calculated by dividing dividend by closing price. Yes, it is an annualized yield.

$$\text{Dividend Yield} = \frac{\text{DPS}}{\text{Closing price}} = \frac{1.44}{45.50} = 3.2\%$$

c. PE indicates the willingness of the investor to pay for the stock for every rupee of the earnings. It is calculated as follows:

$$\text{PE Ratio} = \frac{\text{Close price}}{\text{EPS}}$$

d. 103 round lots or 10,300 shares were traded on the trading day.

Problem 6.3

Soln

a. Price of Everest Bank shares is more volatile than the price of life Insurance corporation Nepal because EBL price fluctuated in the range of Rs. 6 (522-516) while that of life Insurance only fluctuated in the range of Rs.1 (125-124). Larger price movement of the Everest Bank share implies that it has more price risk.

b. The NEPSE index of 208.82 means it increased by Rs. 108.82 from the base price of 100 and +0.07 means the NEPSE is increased by 0.07 points from the previous day's closing price.

Problem 6.11.

Soln

Given:

Stock split ratio = 3 for 2

Stock price before split = Rs.300

Stock price after split = stock price before split X stock split ratio

$= 300 \times \frac{2}{3}$ OR, $\frac{300}{3/2}$

$= Rs.200$ $= 300 \times \frac{2}{3} = Rs.200$

Number of shares before split = 200 shares

Number of shares after split = No. of shares before split X stock split ratio

$$= 200 \times \frac{3}{2}$$

$$= 300 \text{ shares}$$

Problem 6.12

Soln

Stock dividend rate = 25%.

Price before stock dividend = Rs. 49.75

a. Number of shares before stock dividend = 100 shares

Number of shares after stock dividend = No. of shares before stock dividend (1+SDR)

$$= 100 (1+0.25)$$

$$= 125 \text{ shares}$$

b. Price after stock dividend = $\frac{\text{Price before stock dividend}}{1+SDR}$

$$= \frac{49.75}{1+0.25} = \text{Rs. } 39.8$$

c. Stock dividends are non-taxable income whereas cash dividends are taxable income, so investors might choose stock dividends.